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The EU-Ukraine FTA: First feedback from regional consultations

Having acceded to the World Trade Organization this year, Ukraine immediately began direct negotiations with the EU on setting up a free trade area. What costs and benefits from setting up this free trade area will face the Government and Ukraine's businesses? How prepared are Ukrainians to adjust to EU standards? How can they get better access to EU markets? The Centre's analysts looked for answers to these questions during consultations in four major cities as part of the "EU–Ukraine FTA: Analytical, methodological and informational support for negotiations" project

ICPS efforts a good foundation for the FTA

Over the last two years, ICPS has been contributing to formulating a strong position on the part of the Ukrainian Government during negotiations to set up a free trade area with the European Union. Together with EU donors, in particular the European Commission, the ICPS experts launched a series of projects on this in 2006.

In the first part, implemented jointly by ICPS specialists and partners from the Center for European Policy Studies and the Institute of World Economy (Kiel), a report called "The Feasibility and Economic Benefits of an EU–Ukraine Free Trade Agreement" analyzes options for economic integration that might be the most beneficial to Ukraine. In 2006, ICPS analysts successfully implemented a project called "Public consultations on an EU–Ukraine FTA."

In September 2007, ICPS received funding from the Swedish International Development Agency (SIDA) to move to a new aspect of this free trade area. As part of the "EU-Ukraine FTA: Analytical, methodological and informational support for negotiations" project, ICPS experts and government officials are analyzing the impact of a Free Trade Agreement at the macro level. They are also analyzing the opportunities and consequences of Ukraine's participation in the Union's agencies and programs.

Consultations with regional stakeholders

ICPS and the Ministry of Economy have already held debates on the possible impact and prospects of a Free Trade Agreement in Dnipropetrovsk, Donetsk, L'viv and Uzhhorod. The purpose of these consultations was to organize a meaningful public dialog between the Government, interested business entities and analysts as to a clear position for the Ukrainian Government during negotiations on an FTA with the EU.

During these roundtables, participants, primarily representatives of businesses, discussed three main questions:

- What impact will Ukraine's accession to the World Trade Organization have on your sector or business?
- What EU markets are of interest to you today? What barriers to entry are there on these markets?
- Do these markets interest you in the longer term and are you prepared (at the sector or business level) to adapt to EU standards (and to the costs involved), to give you the prospect of better access to EU markets?

What regional businesses think

On the whole, participants agreed that the EU market is quite promising for Ukrainian businesses, while the compliance of Ukrainian products to the EU standards is one of the important pre-conditions for expanding opportunities to export such products. However, businesses say they currently face an information vacuum on recently instituted standards, in particular in chemical industry as regards REACH, the new European Community Regulation on chemicals and their safe use.

At the same time, some businesses pointed out that compliance with EU standards was a necessary, but not sufficient condition. The low level of informedness among European consumers about Ukrainian products hampers their promotion on the markets of the EU Member States. So, in addition to costs for product standardization and certification, Ukrainian businesses need to spend a lot of money on promotion.

Some companies said that the impact of accession to the WTO was more important at this time for them than an FTA. Although the consequences of accession are still not totally known, some businesses expect existing trade restrictions on Ukrainian exports to the EU, such as on piping, to be lifted.

Participants also noted that, after signing a free trade agreement, competition should grow significantly stronger on the domestic market. The losses from liberalizing trade will affect SMEs, as well as consume, as many customary goods, primarily food products, disappear as major corporations and big international brands take over Ukrainian markets.

All participants were clear about the need to increase the competitiveness of Ukrainian enterprises. Among measures that would help this, businesses tended to consider access to investment, financial and high-quality human resources more significant than protectionism and breaks, which many felt had proved ineffective. Specifically, many companies complained about the lack of coordination between vocational education and training and actual business needs, and, hence, the lack of skilled labor.

Businesses agreed on the need for consultations between business and the Government in preparing for negotiations with the EU on an FTA. However, the business community noted the ineffectiveness of such consultations in the past. The level of communication among enterprises, sectoral associations and ministries continues to be poor, while proposals from associations and unions have very little impact on the decision-making process.

ICPS partners in the "EU–Ukraine FTA: Analytical, methodological and informational support for negotiations" project are the Ministry of Economy, the Ministry of Foreign Affairs and the Secretariat of the Cabinet of Ministers. The goal of this project is to improve the process of Ukraine's economic and trade integration with the European Union by providing analytical, methodological and informational support to Ukraine's central and local governments, business community and the media.

The Centre's partners in organizing debates in the regions were: the European Business Association, the Donetsk and L'viv Chambers of Commerce and Industry, and the regional branch of the National Institute for Strategic Studies. ■

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The phantom of appreciation

The undervaluation of the hryvnia continues to be Ukraine's competitive advantage, just like the undervalued currencies of other dynamically developing countries—from Russia to China and Brazil. As the appreciation carried out in 2005 showed, strengthening the hryvnia does not stop inflation: from April to August 2005, inflation just steamed ahead, writes ICPS economist Oleksandr Zholud in his article for Ekonomichna Pravda, an online publication

Conditions for strengthening the hryvnia

Unlike his European and American counterparts, Governor of the National Bank of Ukraine (NBU) Volodymyr Stelmakh rarely makes public speeches. This is why people listen very carefully to each of his statements, looking for hints about the NBU's plans.

On 18 February, Mr. Stelmakh stated that the pre-conditions for strengthening the hryvnia were now in place. Many people interpreted this as the National Bank intending to appreciate the hryvnia against the US dollar in the immediate future. However, no appreciation was carried out after a similar statement last year. A year ago, Mr. Stelmakh said that there were economic grounds for strengthening the hryvnia, but it was necessary to see how this would affect different sectors of the economy.

According to analysts, the fundamental reasons that are creating pressure to appreciate the hryvnia, first of all, include the significant inflow of foreign currency to the country. Indeed, despite the negative balance of foreign trade that raises the need for foreign currency to cover this deficit, the NBU increased its reserves by US $10.2bn in 2007.

However, this year, the situation is somewhat different: in January, NBU reserves shrank US $668mn. According to preliminary data for February, the NBU sold foreign currency on the interbank foreign exchange market at least three times. This means that there is no immediate pressure on the hryvnia.

The official UAH/USD rate not revised in three years

Ukraine and Turkmenistan are two CIS countries that have not revised their official exchange rate against the US dollar in the last three years. The majority of other CIS countries have appreciated their currencies during this time. A similar situation has emerged in Central and Eastern Europe over the last few years. The Czech Republic, Poland and Hungary appreciated their currencies against the dollar and the euro.

This, along with the fact that the hryvnia is one of the most undervalued currencies in the world, is additional incentive to strengthen the currency.

Although the official UAH/USD exchange rate has remained absolutely unchanged since August 2005, inflation has had its effect. Both the dollar and the hryvnia have less purchasing power in Ukraine than a year or two ago.

After the appreciation of Spring 2005, the real effective exchange rate (REER)—that is, the nominal exchange rates against the currencies of Ukraine's trading partners, taking into account inflation in these countries and in Ukraine—has been almost unaltered. The fall of the US dollar against the ruble and the euro (Russia and the EU are Ukraine's key trading partners) has been compensated by faster growth in prices in this country. That is, the situation with the exchange rate is similar to what could be seen after appreciation in 2005. The foreign trade balance is putting pressure more towards depreciation, while the flow of capital from abroad remains under question because of the global financial crisis.

Last year, large volumes of foreign currency flowed to Ukraine due to overall optimism regarding the world economy as a whole and developing markets in particular. This attitude shifted considerably after a mortgage crisis that began in August in the US, has not been eliminated yet, and will continue to make itself felt this year.

Earlier, domestic banks actively borrowed abroad. Although this crisis did not have a direct impact on Ukraine, it forced Ukrainian banks to look for sources of financing as an alternative to international borrowings. For instance, in H2'07, it became more difficult for domestic banks to issue Eurobonds. In Q3'07, banks still continued to issue Eurobonds, based on loan agreements concluded before the crisis. By Q4'07, Ukrainian banks stopped issuing Eurobonds altogether.

As a result, Ukraine's banks began to borrow actively on the domestic market, significantly increasing the volume of loans compared to the previous year.

As fluctuations among global stock indices over January–February 2008 showed, the 2007 financial crisis has not gone away yet. This means that, most likely, investors will be more cautious, even about lending money to new economies, including to Ukraine.

An undervalued hryvnia is to Ukraine's advantage

There is also the psychological factor. In seven years of relatively strictly pegging of the hryvnia to the US dollar, Ukrainians have grown accustomed to a stable exchange rate. Nobody can definitely tell how economic agents—businesses, households and investors—will behave if hryvnia appreciation is undertaken. In such a situation, it makes sense to liberalize the hryvnia exchange rate very carefully, over a long period of time, rather than instantly. This is why Ukraine will most likely not see any changes in the official hryvnia-dollar exchange rate any time soon. ■

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